A.I.D. EVALUATION HIGHLIGHTS NO. 3
May 1989

The Effectiveness and Economic Development Impact of Policy-Based Cash Transfer Programs: The Case of Honduras

PN-ABC-864

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SUMMARY

Since 1984, the Agency for International Development (A.I.D.) has been the largest donor in Honduras, with its assistance centered on a policy-based Cash Transfer program. Cash Transfers were originally designed in 1982 to complement the International Monetary Fund (IMF)-supported economic stabilization program adopted by the Government of Honduras. However, after the IMF terminated its Standby Agreement in late 1983, A.I.D. found itself as the only donor providing balance of payments support to that country. Cash Transfers rose from 0.6 percent of the gross domestic product (GDP) in 1983 to as much as 3.4 percent in 1986.

A.I.D. found that Honduras's severe economic problems were more intractable than originally thought as prices for export commodities remained low, the amount of international lending was below expectations, and private investment decreased because of a lack of investor confidence. A.I.D. correctly judged that, in addition to the difficulties caused by regional political instability and erratic commodity prices on the world market, major structural weaknesses in the economy had to be addressed.

As a result, A.I.D. Cash Transfer programs since 1984, while still focusing on achieving needed economic stabilization, have also sought to implement structural adjustment reforms as a means of promoting growth. This new program shift was affirmed by the U.S. Central America Initiative (CAI), a plan that focuses on achieving broad-based economic growth while strengthening democratic institutions and processes as a means of reducing regional political instability.

Since 1984, some important improvements have been made in reducing the rate of inflation, increasing levels of employment, achieving divestiture of state-owned enterprises, and providing incentives for nontraditional exports. However, there has been very halting progress on the implementation of other major reforms, such as expanding the parallel market for foreign exchange, which would contribute significantly to achieving sustained, higher rates of economic growth.

The slow progress of the A.I.D. Cash Transfer program in promoting sustained economic growth and in bringing down the

fiscal deficit must be evaluated in the context of the CAI and overall U.S. foreign policy concerns in Honduras. At times, A.I.D. funds were withheld because the Government failed to make necessary policy reforms. But those funds were often made available to support U.S. political interests. The evaluation of the program, particularly from 1984-1987, reflects the tension between U.S. interest in encouraging economic policy reforms and U.S. political concerns.

A.I.D. has clearly adapted to these conditions by moving away from targeted conditionality to more informal policy dialogue. The Mission s constant interaction and discussions with the Honduran Government, in the context of informal policy dialogue, are largely responsible for the achievements made.

BACKGROUND OF THE PROBLEM

Historically, Honduran economic growth has been relatively slow, although there was a period of particularly strong growth in the late 1970s. In the early 1980s, the recession in the industrial countries, high international interest rates, falling commodity prices, and political instability in Central America all combined to put the economy into a tailspin. In 1982 GDP declined by 2.6 percent and investment, which had been 25 percent of GDP in 1980, fell to 12.4 percent of GDP. The Government responded with an expansionary fiscal policy centered on large infrastructure investments. Between 1981 and 1984 public sector investment, as a percentage of GDP, grew from 7.7 percent to 13 percent. Monetary policy accommodated increased public sector deficits as credit to the public sector increased 47 percent in 1982 and 28 percent in 1983. The overall public sector deficit increased from 7.4 percent of GDP in 1980 to a peak of 11.4 percent in 1984.

The economic recovery that started in 1983 was fueled by high public sector outlays and financed by a rapid monetary expansion and large foreign borrowing. Such an approach was not sustainable without an increase in private investment. However, with the uneasy political situation in the region, the rate of private investment was half that of the late 1970s. For economic recovery to take hold, structural reforms and political stability were needed.

A.I.D.'S ASSISTANCE APPROACH

In the early 1980s, most international experts, including many in A.I.D. and the IMF, viewed Honduras's balance of payments difficulties as the downside phase of a normal international business cycle. Thus, Honduras appeared to need nothing more than short-term financing to help it ride out the international recession.

In 1982 and 1983 A.I.D. provided Economic Support Fund (ESF)

Cash Transfers that focused on short- run stabilization. The ESF Program was closely linked to IMF conditionality. The first step in the stabilization program was a sharp dose of fiscal and monetary discipline. Although export revenues were expected to recover after the 1982 slump, making possible higher imports and increased fiscal revenues, the loss of external sources of financing continued, and export revenues remained depressed.

Toward the end of 1983 policy reforms were becoming more difficult, and the Government of Honduras proved unwilling to undertake the IMF's recommended devaluation and fiscal discipline measures. The collapse of the IMF agreement triggered the suspension of A.I.D. Cash Transfer disbursements. The IMF did not resume its program in Honduras, and A.I.D. was left with the tough political decision on whether to go it alone.

The decision to continue an ESF Program in Honduras was based on the development of a wider U.S. strategy for the Central America Region. In 1984, the CAI was designed in response to the recommendations of the National Bipartisan Commission on Central America to stem a growing foreign policy and security crisis in the region. The goals of the CAI are to strengthen democratic institutions and processes, promote economic stabilization, lay the basis for sustained economic growth, and improve equity and the spread of benefits of economic growth. Hence, the Cash Transfer programs became part of the economic assistance package for Honduras, formulated to contribute to the achievement of the goals outlined in the CAI. These foreign policy objectives were to affect the rate and content of progress under the policy-conditioned Cash Transfers.

In addition, the absence of any IMF assistance, the continued stagnation of export earnings, and what was viewed as insurmountable opposition from most sectors of Honduran society to significant further policy reforms created a situation in which a major economic and institutional crisis could have developed. Not only incipient democracy but also the broader U.S. Government objective of a regional security balance was believed to be at risk. Thus, by 1984 political pressures forced the disbursement of $38 million that had been withheld pending Honduran Government policy reform compliance. Additional funds were disbursed in 1984, with few covenants or significant policy conditions. These Cash Transfer disbursements were heavily influenced by political pressures from the highest levels of the U.S. Government, stemming from the desire to allow a democratic ally of the United States more economic breathing room in the short term.

The 1985 Cash Transfer program represented a major departure from previous programs. A.I.D. support was recognized and accepted as the only source of balance of payments assistance, and the policy dialogue was expanded from short-term stabilization concerns to include a larger number of structural reform issues. A.I.D. withheld Cash Transfer disbursements when the government failed to pass a tariff law and failed to expand the self-financing foreign exchange regime. Growing distrust between the U.S. Government and the Honduran Government contributed to the decision to withhold disbursements. In 1986, with a new government in power that appeared ready to launch economic reforms, the outstanding Cash Transfer funds were disbursed.

Cash Transfers disbursed to Honduras from 1982 through the final disbursement of the 1987 program in January 1988 amounted to $420 million. These Cash Transfers increased from a low of 0.6 percent of GDP in 1983 to a high of 3.4 percent in 1986. They represented 6.9 percent of the deficit in the balance of payments current account in 1983, and 51.2 percent in 1986. Clearly, these resources have been an important addition to the Honduran economy.

A.I.D. POLICY REFORM MEASURES AND THEIR ECONOMIC IMPACT

Government Fiscal Policy

Strong opposition to further fiscal austerity measures, such as cutting government expenditures, containing cost, and enforcing hiring freezes, prevented A.I.D. from including these standard features in Cash Transfer conditionality. Instead, the Cash Transfer programs encouraged the rationalization of public sector operations, the introduction of new taxes, and the improvement of tax administration. However, the impact of these measures on the Government deficit was minimal. The government deficit, which was 7.4 percent of GDP in 1980, peaked at 11.4 percent in 1984 and was 7.8 percent in 1986.

The impact of these measures from a broad macroeconomic perspective has also been limited. Government revenues have eroded because of various tax incentives, a cumbersome array of exemptions, and the outright avoidance of tax obligations still in effect. An ad valorem tariff system, required by Cash Transfer conditionality since 1982, but not passed until 1987, should help to reduce the deficit, but the effects will take some time to be felt in the economy.

Economic Stabilization and Monetary Policy

Economic stabilization efforts have been a major component of the Cash Transfer program since 1982. Beginning in 1985, the A.I.D. program not only pursued an aggregate macroeconomic equilibrium but also sought to encourage private sector development. Monetary objectives were designed accordingly, and conditionality sought to address regulations that limited the private sector's access to credit by eliminating preferential treatment to the public sector. The results were very positive in 1985 and 1986; domestic inflation was set on a downward trend, and money supply and credit expanded within reasonable rates. Also, compliance with overall credit targets was satisfactory.

In 1987 the monetary program suffered a major setback, as total credit expansion soared and the money supply rose sharply. Economic activity surged above targeted levels as credit expansion to the public sector increased more than three times as fast as targeted, and provision of credit to the private sector increased nearly twice as fast as targeted. As a result, balance of payments pressure intensified. A.I.D. again withheld Cash Transfer funds, and the government was required to take substantive corrective action. However, late in 1987 A.I.D. released the funds because of progress made in privatization measures, the enactment of the ad valorem tariff system, and Government assurances that it would deal with the monetary situation.

Foreign Exchange Regime Reforms

Honduras's balance of payments problems have been due partly to the erratic nature of commodity prices, but mostly to an overvalued and inflexible exchange rate that is biased against exporters. As a result, Honduras has been losing export price competitiveness. Exporters face a lower price in lempiras for their products at the official rate than they would at a market-determined rate, making investment in the export sector unattractive. In addition, most exporters are required to surrender their foreign exchange earnings to the formal banking system, which prevents them from benefiting from the higher parallel rate.

To help correct these biases A.I.D. proposed an increase in the use of the self-financed parallel market. Targets were set under the 1985 Cash Transfer program to double, within a year, the percentage of total trade covered by open and nondiscriminatory arrangements in the parallel market. However, only minimal progress was made; therefore Cash Transfer disbursements were delayed. In the 1987 Cash Transfer program, no specific targets were set for the growth of the parallel market, but the issue was informally pursued in policy dialogue with the government. By the end of 1987 the government announced a new program to allow exporters in 11 nontraditional categories to retain 30 percent of their foreign exchange earnings in the form of tradable certificates. The certificates can be exchanged immediately for dollars to purchase items through the self-financed market, used to meet interest payments or tax payments, or sold to other firms requiring foreign exchange. The exporter receives the parallel market rate for such transactions. Although the program was very small in proportion to total trade, it was a big first step in introducing needed foreign exchange flexibility.

Trade Policy and Export Promotion

As a small country, Honduras relies heavily on imports for production inputs and consumer goods. Yet, in addition to the discriminatory exchange rate regime, several other major barriers, such as heavy export taxes, restrict the country's ability to earn foreign exchange with which to pay for these imports. Exporters have been unable to import sufficient quantities of inputs necessary for their production processes. The problem is compounded by a cumbersome system of import tariffs and tariff rebates for certain classes of firms and cooperatives.

A.I.D.-supported economic policy changes were aimed at rationalizing trade policy and enhancing export competitiveness through the enactment of several new laws. For example, the Temporary Import Exclusion Law has simplified the import tariff exemption procedures for firms that export 95 percent or more of their output and helped to offset the disincentive of low returns on exports because of overvaluation of the lempira. The A.I.D.-supported Export Incentives Law provides for an income tax rebate to producers of nontraditional exports.

While both laws have provided improved export incentives, the detailed qualification procedures have prevented most small-scale manufacturers and farmers from participating. Also, while the A.I.D.-supported measures have resulted in some export increases, they still cannot substitute for the implementation of an appropriate exchange rate policy, something that the government remains reluctant to do.

Encouragement of Privatization

The budgetary cost of inefficient state-controlled enterprises is high in Honduras. The IMF has estimated that transfers from the Honduran Government to public financial enterprises to cover debt interest payments were equivalent to 4 percent of GDP in 1984.

In 1985, Cash Transfer conditionality required the Honduran Government to establish the legal basis for the sale of public sector-owned enterprises. The Honduran Divestiture Law was submitted and passed that year. In 1987, the government privatized five firms, with A.I.D. encouragement. A 3-year objective of privatizing 12-15 firms was supported by the A.I.D.-Government of Honduras Privatization of State-Owned Enterprises project and Cash Transfer program conditionality. Progress to date puts Honduras in the forefront of privatization. It is predicted that the privatized firms will contribute significantly to improved fiscal accounts through the elimination of some subsidy payments, application of sales proceeds to public debt, and over the long run, increased tax revenues.

FINDINGS

Fiscal Policy

Cash Transfer conditionality in Honduras has not included targets for government expenditures, cost containment, fiscal budget controls, and enforcement of a hiring freeze as measures for bringing down the deficit. Instead, the Cash Transfer program has dealt with these issues through informal policy dialogue, or indirectly, through setting limits on the expansion of credit to the public sector through the monetary components of the program (as, for example, with the budget deficit issue). Although explicit measures might have been more effective in bringing down the deficit, strong opposition within Honduran society against further expenditure reductions and U.S. Government foreign policy concerns prevented stronger policy reform actions from being taken. And it is important to note that A.I.D.'s influence in promoting changes in Honduran Government fiscal policy derives from informal policy dialogue discussions held between the USAID Mission and the Government of Honduras.

Economic Stabilization Efforts and the Credit Surge

Various factors contributed to the 1987 credit surge that threatened the earlier gains made in stabilizing the economy. A government-mandated reduction in interest rate ceilings in December 1986 triggered an unusually large demand for private sector credit; pressures of the fiscal deficit on the financial system increased significantly; and the share of deficit requiring domestic financing jumped from an equivalent of 3.3 percent of GDP in 1986 to 4.0 percent in 1987. Monetary authorities encountered an unexpected delay in the Honduran Congress's authorization of new limits for the national debt and for the refinancing of a special class of government bonds, forcing the treasury to increase its use of banking sector credit disproportionately and to run substantial overdrafts. And finally, there was disagreement within the Central Bank over the desirability of the monetary targets set by the Cash Transfer program. Many Bank officials believed that A.I.D. targets were stricter than those that would have been in effect under an IMF-funded program.

Foreign Exchange Regime

Efforts to expand the use of the self-financing parallel market for foreign exchange as a means of promoting greater export activity were greatly slowed down by the government. Timetables established under Cash Transfer conditionality were clearly not met, and, in general, there was strong adverse political reaction against this measure. It was not until A.I.D. tried to promote the idea through informal policy dialogue that modest successes were achieved in the foreign exchange regime.

A.I.D. s willingness to continue promoting politically unpopular reforms at a much slower pace and through alternative means has been crucial to any forward movement in effecting economic policy changes.

Export Promotion

Increases in export activity have on the whole been minor. While some of these improvements can certainly be attributed to changes in laws and regulations conditioned under the Cash Transfer program, external factors and the government s reluctance to institute a more flexible exchange rate policy continue to slow progress. In 1986 the trade deficit dropped dramatically, from $152 million, or about 9.7 percent of GDP, to $57 million because of high coffee prices and lower prices for petroleum, a major import. However, a reversal of those favorable conditions in 1987 led to a deterioration again in the terms of trade, and a sharp increase in the trade deficit to $122 million, or 8 percent of GDP.

Commodity prices for traditional exports are at the mercy of fluctuating world markets, leaving the country vulnerable on the trade front. To improve Honduras's price competitiveness and lower the trade deficit, continued efforts must be made to promote nontraditional exports and to reform exchange-rate policy.

Privatization

Progress in privatizing major state-controlled enterprises has been excellent. A contributing factor may have been , the A.I.D.-Government of Honduras Privatization of State-Owned Enterprises project, jointly designed in 1986 to provide technical assistance and funding for divestitures. Local currency generated from the Cash Transfer program was used for credit, severance pay, and technical assistance costs. Detailed economic analyses were conducted under the project, with projections made for both privatization and nonprivatization scenarios. The analyses showed significant profitability under privatization for three money-losing state-controlled firms, and positive contributions to GDP.

Rate of Policy Reform Progress

The overall rate of progress in the A.I.D.-sponsored program has been slow. The Honduran Government has often been able to delay its compliance with major elements of the program in full expectation that U.S. foreign policy concerns for Honduras as a democratic nation would ultimately result in disbursement of Cash Transfer funds. Indeed, funds held up from the 1985 program because of poor compliance were disbursed in 1986 as a show of support for the new Honduran President, helping to improve relations between the government and the Mission and setting the reform program moving again. But perhaps ultimately more important for the progress of the program was the jointly instituted USAID/Honduras-Government of Honduras monitoring and evaluation system, which included detailed timetables, joint assignment of responsibilities for various policy measures within the relevant Mission and government offices, and progress-reporting mechanisms. The system has succeeded in broadening the support for the Cash Transfer program within the government.

LESSONS LEARNED

Frequent, informal discussions and negotiations between the Missions and host governments can bring results in instances in which conditionality and leverage do not work. The Joint Economic Working Group, established between the Mission and Honduran Government as part of the 1984 Cash Transfer program, has proven to be crucial for these discussions. Following the withdrawal of IMF funding from Honduras in 1983, the Cash Transfer program was considerably expanded and included strong conditionality with the development of an extensive structural reform component. Progress was achieved in promoting privatization and private investment and in improving tax administration.

However, the implementation of other components believed crucial for the growth of the economy met with difficulty. The Mission moved discussion of these reforms to the realm of informal policy dialogue through the Joint Economic Working Group. Although the process of instituting the ad valorem tariff system and expanding the parallel exchange market has been slow, through policy dialogue a measure of progress has been achieved. (Since 1987 additional progress on exchange-rate policy has been made.)

To make disbursements on the basis of substantive government effort rather than on strict compliance with quantitative targets and calendar dates helps to keep the overall reform program moving. When credit expansion soared in 1987, threatening the economic stabilization program, A.I.D. was obliged to withhold disbursement until corrective action was taken. Although the government was not yet in full compliance with the monetary program, A.I.D. finally disbursed the funds in late 1987 because the long-awaited ad valorem tariff system was finally enacted, substantial progress in privatization and other required structural reforms was made, and the government gave strong assurances that it would take measures to adhere to the original credit targets. USAID/Honduras's flexibility and recognition of progress in other important areas prevented the breakdown of an urgently needed reform program.

The presence of both U.S. foreign policy objectives and macroeconomic and structural adjustment objectives probably means accepting slower progress in the latter. For A.I.D., this meant using greater flexibility in enforcing conditionality and timetables designed to implement necessary reforms. In some cases, A.I.D. was overruled by the U.S. Congress and the State Department, which decided to disburse funds despite unsatisfactory Honduran compliance, thus greatly reducing A.I.D. leverage. The situation was further complicated by the Honduran Government's comparatively low level of understanding of economic processes, which necessitated conducting joint studies as a means of better acquainting Honduran officials with the issues. These joint assessment studies were incorporated as part of the Cash Transfer program conditionality. These strategies resulted in slower economic recovery and growth; yet, ironically, economic growth is viewed as a crucial factor in strengthening democratic institutions in Central America--a major strategy of U.S. foreign policy in the region.

Local currency generated by Cash Transfer programs can be programmed for projects and activities that facilitate the goals of policy reform. A.I.D. experience with policy reform programs worldwide shows that complementary institutional, infrastructural, and implementation support is frequently needed to assist governments in achieving reform objectives and goals. In Honduras, funds from the local currency account under the Cash Transfer programs have supported the highly successful Working Capital Fund for Small and Medium Enterprises and the Privatization of State-Owned Enterprises project. The latter project was key in assisting the Government in meeting privatization targets on which fund disbursements were conditioned in the 1986 Cash Transfer program. Significant advances were also made in developing an export support system and establishing a small-business assistance system, both with local currency funds.

OUTSTANDING ISSUES

Fiscal Deficit

The fiscal deficit is still a big problem. A declining proportion of the deficit is being financed by external sources; consequently domestic financing of the deficit has risen from 2.8 percent of GDP in 1984 to 4 percent in 1987. Continued government reliance on domestic resources to finance its deficits will limit credit to the private sector, thus threatening the successes achieved in increasing privatization and encouraging investment in private enterprise.

Equity Concerns

One of the CAI's goals is to improve equity and spread the benefits of economic growth. Yet A.I.D.-supported legislation under the Cash Transfer program for enhancing export competitiveness, specifically the Export Incentives Law and the Import Exemption legislation, favors only larger, formal-sector firms in the economy. Requirements for applying successfully under these new laws preclude participation by most small-scale manufacturers and farmers. A.I.D. and the Government of Honduras will have to address those aspects of the new legislation, as well as existing regulations for exporters, to remove these kinds of biases and to broaden the opportunities and incentives for all firms that wish to export.

Foreign Policy Objectives and Dependency

The sustainable rate of economic growth needed to help reduce the deficit, finance imports needed for consumption and export production, and maintain incomes and employment levels is not yet ensured by the government s policies. For example, the government continues to move slowly on expanding the self-financing parallel market, which would clearly facilitate export expansion. In addition, there are still parts of the tax code to which specific, rather than ad valorem, taxes are levied, which limits the benefits of the ad valorem tariff reform. Despite cases of noncompliance A.I.D. has often had to disburse funds because of U.S. political concerns. As a result, Honduras continues to be dependent on the substantial resources provided by Cash Transfer payments. Under the prevailing conditions of foreign policy concerns, and the slow pace of government implementation of reforms, even the progress that the country has made in raising employment and income levels is of questionable sustainability without continued assistance for the foreseeable future.

This summary, by Patricia Vondal, is based on an evaluation study of the Honduras Cash Transfer program. The study, which was prepared by Robert R. Nathan Associates, Inc. for A.I.D.'s Center for Development Information and Evaluation and the Bureau for Latin America and the Caribbean, was completed in November 1987, and the judgments are based on data available at that time. The views and interpretations expressed herein are those of the author and should not be attributed to the Agency for International Development. Any comments or inquiries about this evaluation should be sent to the Center for Development Information and Evaluation, Bureau for Program and Policy Coordination, Agency for International Development, Washington, D.C. 20523-1802.